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Submission Category - Individual

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The President's Advisory Panel on Federal Tax Reform
1440 New York Avenue NW, Suite 2100
Washington, D.C. 20220

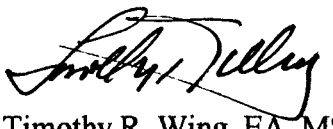
Dear Panel:

The following constitutes my comments on the reform of the Internal Revenue Code ("IRC"), as requested by the President's Advisory Panel on Federal Tax Reform (the "Panel").

It is our opinion that the IRC actually works rather well, save for a number of high profile glitches that have found their way into the media on a regular basis. Dependent upon whose information one uses, it has generally been established that a significant amount of the country's tax revenues are generated from the wealthy, however that group is defined. An increasing number of the populace pay no income taxes at all. So the question becomes, in other than a political way - what is wrong with that picture?

Certainly, one of the glitches that I refer to above revolves around the current [in our opinion incorrect] taxation treatment of employee stock options ("ESOs"), both nonqualified stock options ("NSOs") and incentive stock options ("ISOs"). Our comments to follow are in response to your four bulleted points of complexity-fairness-decision-making and panel goals. We will address these issues as they relate to the current tax treatment of ESOs. We also will provide specific proposals when we are called upon to do so.

Very truly yours,



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Complexity

The current incorrect taxation treatment of ESOs manifest all of the bullet points established by the Panel. ESOs are currently taxed at exercise. An option is a right to buy some asset, usually associated with common stock of publicly-traded companies. If you have the right to buy shares in XYZ common stock when it is trading for $50 per share in 2005, and it subsequently appreciates to $100 per share by 2010, then you have income in 2010 of $50 per share at ESO exercise [$100 fair market value in 2010 minus the $50 exercise price paid].

ESO taxation at exercise results in ordinary income to the option holder. Our current tax system is designed to take maximum advantage of this event. Not only are option holders exercising ESOs usually in the highest tax bracket in the year of exercise [35%], but certain of their itemized deductions are denied them as their adjusted gross income [AGI] increases.

An ISO is an option that is not taxed for regular tax purposes upon exercise. Rather the value at exercise is added into the alternative minimum tax ("AMT") calculation. ISOs exist with a number of holding period requirements that must be met to achieve the favorable tax benefits of the ISO i.e., that the bargain element excluded from the regular income tax instead be taxed at the more favorable capital gain tax rates.

In our opinion, there is no greater mismatch of IRC complexity and taxpayer capabilities as there is in ESO taxation, particularly ISOs. It is common knowledge that popular tax software

titles, as well as the IRS, do not deal with these tax issues properly. These complexities have resulted in numerous lawsuits over the last five years relating to improper ESO planning.

Fairness

There has been a great deal of discussion lately on the encroaching effects of the AMT and that the AMT, as it exists today, has overreached the original intent of Congress. The same can be said for the current tax treatment for ESOs, which is based on the exercise of the option:

> *The Congress intends that in applying these rules for the future, the Services will make every reasonable effort to determine the fair market value for an option (i.e., in cases where similar property would be valued for estate tax purposes) where the employee irrevocably elects (by reporting the option as income on his tax return or in some other manner to be specified in regulations)* ***to have the option valued at the time it is granted*** *(particularly in the case of an option granted for a new business venture). The Congress intends that the Service will promulgate regulations and rulings setting forth as specifically as possible the criteria which will be weighed in valuing an option which the employee elects to value at the time it is granted. [emphasis added]*

-Tax Reform Act of 1976, General Explanation, page 154. See also S Rep No. 1236, 94th Cong. 2nd Session, 438-439.

Congress intended that ESOs be taxed at grant. The IRS, against the will of Congress, against

the will of the people, decided to do it their own way. So, two of the more confusing areas in tax i.e., the AMT and ESO taxation at exercise, lack a clear legislative mandate.

Constitutional issues arise with ESO taxation at exercise related to equitable treatment under the law. I direct your attention to Robert McGough's July 28th, 2000 Wall Street Journal *Heard on the Street* article, *'Tech Companies Liberal Use of Stock Options Could Swamp Investors, Drain Firms' Resources.'* McGough asserts that of the $570 billion in stock option gains for S&P 500 companies [for 1999], approximately $330 billion came from the S&P 500 Tech Sector. Of the $330 billion, approximately $180 billion came from just six companies in the Tech Sector who, in the aggregate, had just $12 billion in actual earnings. A relatively small group of companies are benefitting financially from the current exercise date tax treatment of ESOs, as income generated from ESO exercise provides a compensation expense deduction i.e., tax savings, to the employer corporation. ESO exercise taxation is a significant source of cash for many companies.

Taxpayer Decision-Making

The original intent of ESOs was to promote company common stock ownership i.e., to align the interests of the employee with the interests of the company. At exercise, the ESO holder must pay both the exercise price and tax withholding [both federal income tax and FICA]. Usually, these cash outlays require the sale of the employer stock at exercise. This is substantiated by the fact that over 90% of ESO exercises are done as cashless option exercises where the stock

underlying the ESO is sold at ESO exercise. This works against an employee making a long-term investment in his employer's common stock.

Goals

The Panel would probably want to entertain changes to the IRC that gave them the biggest bang for their buck, so to speak. A goal should be to minimize the expense associated with such IRC reform and to determine the revenue neutrality of such IRC reform, if possible. A collateral issue would also be the relief factor of such reform and, in our opinion, the elimination of ESO taxation at grant would dramatically reduce the cost and complexity of the taxpayer compliance burden. Another collateral issue might be whether or not such IRC reform provides other multi-disciplinary benefits. The elimination of ESO taxation at exercise would allow coordination with the Financial Accounting Standards Board's recently released Statement of Financial Accounting Standard No. 123r, ***Share Based Payment.*** This Standard now requires valuation of ESOs at grant for financial reporting purposes. Corporations would then be able to use one number for ESO valuation, for both financial reporting and tax purposes. This alone would be an extraordinary benefit for corporations and employees.

The other specific benefits provided by the elimination of ESO taxation at exercise are too numerous to mention here. We look forward to presenting them in greater detail when submitting our proposal in this comment area at the appropriate time.